

# **UNIQUE ATTRIBUTES OF THE POSTAL SERVICE BUSINESS MODEL: PREPARED STATEMENT TO THE PRESIDENT'S COMMISSION ON THE UNITED STATES POSTAL SERVICE**

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**Michael A. Crew, Professor of Economics, School of Business, Rutgers –  
the State University of New Jersey**

My statement argues that the business model of the United States Postal Service is seriously flawed. It examines four basic attributes of a viable business model that are deficient in varying degrees in USPS. It then goes on to suggest a number of reforms that would go some way toward providing a viable business model for USPS.

A viable business model for the United States Postal Service should include at least four features. First, there should be a governance structure that attracts highly qualified top management, mainly by providing an appropriate incentive and reward structure. Second, there should be freedom to introduce new products or services without undue delay for regulatory clearance. Third, management should be able to control its principal input costs, which, in the case of postal service, is labor. Fourth, the regulatory framework should allow for growth or change while preserving the Universal Service Obligation (USO) and offering some protection for small customers. These features are not controversial. For regulated industries generally, any viable business model would be expected to have these features. USPS is deficient in varying degrees in these four attributes as outlined below and examined in more detail in the attachments.

## **1. Attributes of a Viable Business Model**

The current business model for USPS lacks at least four principal attributes of a viable business model.

### Ability to Attract Highly Qualified Top Management

USPS has a salary gap for its top management equivalent to the Civil Service salary cap. This may work well in the Civil Service but it does not work well at USPS. Despite the salary cap, the Federal Government seems to be able to attract many of the ablest lawyers, economists and managers. The Federal Trade Commission, the Department of Justice, the Federal Communications Commission, the Treasury and so on are very attractive to ambitious economists, lawyers and others who hold high level positions outside government, because they offer very interesting and challenging work, with the opportunity to improve one's skills. In addition, although the majority of such individuals take significant cuts in monetary compensation, it is seen in their minds as an investment in their human capital. With the experience and contacts gained they expect and usually obtain a high return for their time in government. Looked at in these terms high-level government service is not badly compensated since it offers interesting work

and valuable experience that likely results in a significant increase in future earnings. By contrast USPS has little to offer to such talented individuals. It can offer similar monetary compensation to other government posts, but it does not offer great prospects. Few talented individuals would be convinced that an assignment of a few years at USPS would enhance their human capital and therefore future earnings. One reason for this is that there is not the opportunity to have an impact on decision-making and policy that other government jobs provide. The problem is that USPS is a business but it is not run like one. The experience gained is not likely in most cases to be transferable to other businesses. It is not even likely to be very transferable to other post offices in the world, as they consider themselves to be better managed than USPS and therefore have little to learn. USPS is not a source of managerial or professional talent for GE, IBM, Wal-Mart or other successful models of large business.

The combination of inadequate compensation, work that is unchallenging relative to the alternatives, and a lack of prospects mean that USPS is unable to attract the top business men and women who have the ability to make it into the successful business it is capable of becoming.

#### Freedom to Introduce New Products and Services

Successful businesses cannot rest on their laurels. Technology and the business environment do not stand still. Products that were great a few years ago get pushed aside as tastes and technology impact the market place. USPS faces considerable regulatory and other obstacles when it attempts to be innovative. This is not to argue that USPS should be allowed to diversify into all kinds of vaguely related businesses. As long as it is a public enterprise, it is expected to confine itself to mail and closely related products. However, it must recognize the trends that are taking place around it. USPS is part of the communication business, which has undergone dramatic change because of advances in microelectronics and optical fiber apparent in *inter alia* the ubiquity of the Internet and wireless telephony. USPS's traditional high margin products, notably First Class Mail, face severe threats. They cannot be counted on anymore to bail USPS out of its financial difficulties. USPS needs to develop a better understanding of the link between the new electronic technologies and its business. It may mean introducing new parcel and small packet delivery services that compete with the major parcel delivery services. The current regulatory process delays USPS in introducing new products and is employed by competitors to influence USPS pricing of such new products.

#### Cost Controls

Just as a business controls its revenues by product innovation, marketing and advertising, it also has to maintain control of its costs. Around eighty percent of USPS costs are labor and it has exceedingly limited control of these costs. The compensation of its unionized employees is not subject to traditional collective bargaining as practiced in private industry but "interest arbitration." Postal employees do not have the right to strike but in the event of a failure of their union to reach an agreement with USPS they take their case to binding arbitration. Thus, an outsider, an arbitrator, determines USPS principal input,

wages. Over the years, this process has led to a wage premium in excess of 20% relative to comparable wage standards in the private sector. In addition, USPS has nationwide uniform wages, making postal work exceedingly rewarding in some low wage parts of the U.S. economy and making it difficult to hire in high wage areas. Thus, for its significant premium USPS does not get much benefit, one sign of which is its continuing problems with labor relations as evidenced by large numbers of grievances. Postal labor makes its views clear to Congress finding many ears willing to listen on Capitol Hill. All this means that USPS has very little control of its labor costs and faces significant obstacles in achieving productivity improvements.

While its ability to control its labor costs as a result of the peculiarities of collective bargaining process employed is a major problem, there are other forces at work that are detrimental to the control of its costs. In particular, the level and nature of the oversight exercised by Congress on USPS activities is problematic and needs to be changed. Clearly, Congress has an interest in assuring the continuing provision of the USO (discussed below), in providing some protection to consumers, and in assuring that USPS does not exploit any market dominant position it may have. However, such oversight needs to be an arms length rather than Congress taking a more interventionist role. For example, Members of Congress may see considerable benefits in terms of jobs in having a Federal facility, be it a military base, a penitentiary or a mail processing facility in their districts. However, to the extent that Congress directly influences operating or facility closure policies, the ability of USPS management to assure a viable business model for USPS could be slowed up and ultimately compromised. The result would be that USPS operations would be higher cost than they would be if such decisions were made on a commercial basis. Thus, there needs to be a rebalancing of the required autonomy and discretion for USPS management to achieve commercial operations with the information and oversight that Congress should have to assure itself that the national postal infrastructure is viable.

### Regulatory Framework and the USO

USPS faces a major burden in terms of the universal service obligation (USO). This is the obligation to provide ubiquitous service at a uniform price and at a reasonably uniform standard of quality. Quality standards allow some flexibility but the other features of the USO do not. The USO is a major burden on USPS and most POs worldwide. It is basically an obligation to provide extensive cross subsidies between high cost and low cost routes or areas. Absent regulator intervention, a private company could not sustain such an obligation because competitors would undercut it in the low cost areas and routes, leaving it with no margin to support its high cost areas. One role of the regulatory framework is to administer the USO by adjudicating the rights of customers and competitors while safeguarding the obligation to serve. In effect the regulator administers a regulatory contract. Such a process has to balance the rights of the various parties involved.

While it operates within a framework of law, the Postal Rate Commission (PRC) has a significant role in interpreting and administering the regulatory process. Its mandate

cannot be specified in every detail. PRC has considerable discretion in interpreting testimony from intervenors. Depending on the views of the membership of the PRC the treatment that competitors or particular customer groups receive can vary significantly as the PRC has extremely detailed rate setting authority. While its decisions are technically “recommended” they are not easily overturned by USPS management operating through its Board of Governors. The regulatory process inhibits significantly USPS ability to set prices. Similarly, on the issue of closure of post offices the hearing process administered by the PRC places non-trivial restrictions and delays in closing local post offices.

## **2. Possible Reform Scenarios**

The reforms likely to promote a viable business model would need to address the regulatory framework, the labor relations framework and the governance of USPS. Governance might be considered the prime driver, as without changes in it the impact of changes in the other two is likely to be limited. The general idea is that USPS should become more commercial in its orientation. This could be achieved in varying degrees from increased corporatization and commercialization to privatization or ownership by the private sector. Commercialization implies that USPS would function more like a private company although the stock would be held by the Federal Government. A commercialized USPS would expect to be subject to the control of its board of directors as in the case of a privately owned company and not directly subject to Congressional intervention as presently. To bring about successful commercialization would require a significant reduction in the role of Congress. This would be difficult to achieve short of privatization, but, whatever the ultimate institutional form USPS takes, every effort must be made to achieve commercialized operations if USPS is to have the necessary flexibility and structure to accomplish the business and policy objectives noted in section 1.

A number of steps could be taken to increase the commercial orientation of USPS. These would include:

### Board of Directors

The existing Board of Governors would be replaced by a Board of Directors. As such it would resemble the Board of many large corporations, including leading figures from the business world.

### Profit Orientation

Having a private sector style Board of Directors would have little impact unless USPS were allowed in certain basic ways to behave like a commercial entity. This would not be feasible unless the prohibition on retained earnings were repealed. This change along with a Board of Directors would make motivation and compensation of top management less difficult. Profit orientation and ability to retain earnings would give the additional benefit, if successful, of putting USPS finances on a sounder footing. This would make

USPS less vulnerable to Congressional intervention in its business. It would have the most basic independence of all, financial independence. Since Congress would not be paying the piper, it would find it more difficult to call the tune. The Federal Reserve has been successful in maintaining independence from both the legislative and executive branches of government because it has no difficulty funding its activities and even in effect paying a dividend to the Treasury. Ending the prohibition on retained earnings would go some way to giving USPS the desired commercial orientation and independence from government.

### Compensation, Incentives and Working Conditions of Top Management

USPS needs to attract talented top management and commercialization would go a long way to achieving this in that it would involve a change of duties, different incentives and higher compensation, and the ability to make a difference in the future of USPS. One consequence of commercialization is that USPS would become more involved in the “selling business”. It would have to compete and become more innovation oriented. Of at least as much importance there are many other aspects of commercialization and “turnaround” operations that are well known in the private sector and could be brought by knowledgeable executives to USPS, if it were restructured to promote a culture of commercialization.

### Regulation and the USO

The USO would still continue although a commercialized USPS might seek some modifications. The least damaging way to fund the USO would be to continue to allow USPS a “reserved area” where it has a statutory monopoly, which would be administered by the regulatory commission. Based on the attached paper, Crew and Kleindorfer (2002a), it may be possible if other pricing changes are made to have a smaller reserved area than presently. Products outside the reserved area might be considered competitive and not subject to rate setting by the regulator. However, if USPS were a commercial entity, it could face antitrust actions. The precise nature of the regulation – whether it be a variation of price cap, rate of return, or hybrid regulation – is beyond the scope of this statement. Suffice it to say that it would be less detailed than the present process and would allow more commercial freedom to USPS.

### Labor and Other Cost Controls

Detailed discussion of labor reforms are beyond the scope of this statement. A commercialized entity would presumably consider major changes in the existing system including allowing the right to strike and negotiating more productivity oriented labor agreements. Other possibilities might include an employee stock ownership plan (ESOP). Commercialization would involve a radical examination of all of USPS real estate holdings and product facilities and would presumably result in a major rationalization. This could result in the reduction in many mail processing positions and closure of facilities. Of course, such restructuring would have to be accomplished according to agreed principles and prior discussion with the public or its representatives,

but a commercial orientation would leave the actual execution of rationalization strategies in the hands of USPS management.

### Privatization

As indicated in the attached papers, Crew and Kleindorfer (2000, 2002b) privatization of the USPS may be the most efficient solution, with the privatized entity subject to restructured regulation to promote innovation and productivity growth. However, given the weak economy and experience elsewhere, getting from here to there is a challenge. Germany and the Netherlands both began with commercialization and have still not attained full privatization. Other successful experiments in commercialization, for example, Sweden, New Zealand, Canada and Australia, show no apparent interest in privatization. Experience may show that a more gradual commercialization approach may be a superior alternative to a big bang.

### **Attachments**

Crew, Michael A. and Paul R. Kleindorfer, "Privatizing the U.S. Postal Service," in E.L. Hudgins, (Ed.), *Mail @ the Millennium: Will the Postal Service Go Private*, (Ed.), CATO Institute, Washington, DC, 2000.

Crew, Michael A. and Paul R. Kleindorfer, "Balancing Access and the Universal Service Obligation," in Crew, Michael A. and Paul R. Kleindorfer (eds), *Postal and Delivery Services: Delivering on the Competition*, Kluwer, Boston, 2002a.

Crew, Michael A. and Paul R. Kleindorfer, "Developing Policies for the Future of the United States Postal Service", paper prepared for Federal Trade Commission, 2002b.